THE CZECH REPUBLIC'S RISK OF FAILURE TO MEET THE FISCAL CRITERIA

Jan Bureš

The unsatisfactory state of public finance in the Czech Republic represents one of the main problems of the Czech economy. Besides numerous threats associated with the poor state of public finance, in the European integration process the Czech Republic is facing the risk that it might fail to meet the Maastricht Fiscal Criteria and that the adoption of a single currency will be further delayed. The following study aims at outlining how sound the Czech public finance should be so that we could adopt a common currency. Further, we would like to identify the main problematic features of the Czech Republic's public finance as well as to show ways that reformatory efforts should take so as not to jeopardize the adoption of the euro.

The Czech fiscal policy is characterized by growing public budget deficits, a relatively low (but increasing) public debt, and shortcomings in the institutional framework of the budgeting process. The fiscal projection of the Ministry of Finance shows the growing public budget balance in Chart 1[1].

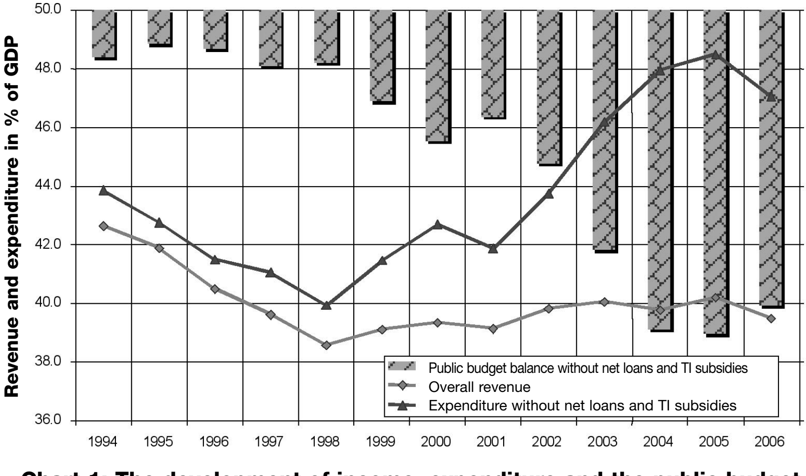

Chart 1: The development of income, expenditure and the public budget deficit between 1994 and 2006 (passive scenario). Source: Czech MF

Table 1: The development of public debt between 2002 and 2006 (passive scenario). Source: Czech MF

Consolidated public debt	2002	2003	2004	2005	2006
debt (Czech Consolidation Agency excluded)	27	30,9	36,8	43,4	47,7

According to the ESA 95 methodology, the public budget was in deficit throughout the whole period of 1994-2006. There was no significant growth in the deficit until 2000 (when it went over 3% of GDP). This is mainly due to the sharp rise in the expenditure-to-GDP ratio. The overall tax-to-GDP ratio (including compulsory social and health insurance contributions) gradually fell until 1998 (38.3% of GDP). It has stagnated since then. Also budget expenditures related to GDP decreased until 1998 (from 44% to 40% of GDP). Since then there has been a significant increase each year (with the exception of 2001), and in 2002 budget expenditures reached 44% again. In an autonomous development scenario the Ministry expects that by 2005 public expenditure will have risen to about 49% of GDP, with a deficit representing about 9% of GDP. According to this scenario, the public debt would reach 47% of GDP in 2006. The figures given above clearly show that unless public finance is reformed, the gap between budget income and expenditure will keep widening and a relatively rapid growth in the public debt will take place.

This development poses other general risks to the Czech economy. High budget deficits reduce the amount of savings in the economy and thus primarily limit investment opportunities. As a result, interest rate growth becomes pressured, and the deficit of the balance of payments current account grows[2]. The balance of payments problems can be further aggravated by the simultaneous decline in the inflow of foreign direct investment (FDI)[3], which has helped to balance the current account deficits to a considerable extent. The growing public debt rapidly increases costs associated with debt management. Moreover, high budget deficits limit efficiency of automatic stabilizers[4] and paralyse possibilities of discretionary fiscal stabilization. Therefore, sound public finance (i.e. cyclically balanced budgets) is vital for the macroeconomic stability of any country, and growing public finance deficits are associated with considerable risks.

In the context of the accession (of the Czech Republic and ten other countries) to the EU, further risks arise from the poor state of public finance. Each of the accessing countries is forming its own strategy for an optimum timing of the single currency adoption. However, neglecting the public budget-related problems or underestimating the planned reform might eventually necessitate postponing the adoption of the euro until more distant future. Also, the Czech Republic might infringe certain EU regulations (the Stability and Growth Pact[5]).

Before entering the Monetary Union the accessing countries have to meet what is referred to as the "convergence criteria" (see Box 1). These criteria should test the particular country's readiness for the adoption of a common currency. Although their appropriateness is disputable from an economic point of view (the criteria remain unchanged largely for political reasons), the strategy of the Czech economic policy will have to take into account that the criteria have to be fulfilled according to the common currency adoption schedule.

Maastricht Convergence Criteria

Exchange rate stability: A Member State has to join the ERM 2 (Exchange Rate Mechanism), participate in it for at least two years before adopting a single currency, and remain within a standard fluctuation band without devaluation of currency[6].

Public budget deficit: The deficit (measured using the ESA 95 methodology) has to be below the reference value of 3% of Gross Domestic Product at market prices. This criterion has to be met the year in which the Czech Republic joins the ERM 2. Exceptions to this requirement include cases when the ratio has declined substantially and is approaching the reference value, or, alternatively, when the excess was only exceptional and temporary.

Public debt: Its amount at market prices (gross total of debts in nominal values at the end of the year) in relation to Gross Domestic Product at market prices must not exceed 60% of GDP. If this is not the case, the ratio must have sufficiently diminished and must be approaching the reference value at a satisfactory pace. This criterion has to be met the year in which the Czech Republic joins the ERM 2.

Price stability: Within one year the average inflation rate must not exceed by more than 1_ percentage points that of the three best-performing Member States with the lowest inflation.

Long-term interest rates: A Member State's average nominal long-term interest rate (measured according to long-term government bonds) must not exceed by more than 2 percentage points that of the three best-performing Member States with the lowest inflation rate.

Central bank independence: The country's legislation must guarantee the independence of the central bank and stipulate a ban on government financing and providing advantaged access to loans.

According to "The Czech Republic's Strategy for Eurozone Accession", a joint document of the Czech National Bank, the Czech Ministry of Finance and the Czech Ministry of Industry and Trade, the euro could be adopted between 2009 and 2010. The Czech National Bank (Dědek, 2003 etc.) originally defended the earliest possible adoption of a single currency, i.e. in 2007[7]. Most central banks of the new Members advocate an early adoption, too. The majority of them will want to adopt the euro at the earliest possible date (see Table 2).

In the Czech Republic there have been lively discussions about when the Eurozone accession should take place. Those who criticize the adoption of a common currency usually base their arguments on what is known as the "optimum currency area theory". They stress the necessity to achieve at least a sufficient degree of harmonization of economic development, mutual business interconnection, and a sufficient degree of real and nominal convergence, so that a single currency would bring minimum risk of asymmetrical shocks or so that there existed instruments promptly reacting to such a shock (a flexible fiscal policy, a flexible employment market). The author of this study is one of those who believe that in a small and highly open economy[8], an early adoption of a single currency itself could accelerate the harmonization of cyclical development, contribute to a greater business interconnection with other economies in the Eurozone, and support the convergence. Conversely, a euro adoption that takes place much later than in the other transitional economies could be harmful. Czech exporters would find themselves at an indisputable disadvantage compared to the other transitional economies, which may have a negative impact on Czech foreign trade. Further delays in the adoption of the euro may cause gradual capital outflow and discourage potential investors, who often consider several transitional economies before placing their investment. Therefore, adopting the euro significantly later than in the other accessing countries poses definite risk in our opinion.

Before a common currency is adopted, sufficient margin of manoeuvre for fiscal policy must be created so that the policy has a stabilizing effect during the Czech Republic's participation in the ERM 2 as well as after adopting the euro[9]. We believe that the flexibility and opportunities of the domestic fiscal policy will decisively influence the speed of Eurozone accession. Meeting the convergence criteria (i.e. maximum deficit 3% of GDP, maximum public debt 60% of GDP) at just one point in time is not sufficient. Public finance must be sound enough so as fiscal policy can replace monetary policy during macroeconomic stabilization. The Ministry of Finance's passive scenario[10] clearly shows that up until 2006 the Czech Republic may face not only growing deficits but also a rapidly rising public debt. According to longer-term predictions[11], public debt might reach 58% before 2009. The Ministry decided to remedy this adverse situation by trying to reform public finance. The success and thoroughness of the reform will probably – and to a considerable extent – affect the Czech Republic's ability to adopt a single currency. However, the other new Members struggle with public finance-related problems, too. Their accession strategy related to how they plan to meet the fiscal criteria is shown in the following table. The deficits and public debts for 2006 are not predicted according to passive scenarios – they already take into account the governments' active measures.

Table 2: Accession strategies and public finance. Source: PEP (2003), Ministries of Finance of Estonia, Poland and the Czech Republic, Šaroch (2003)

country	accession strategy	public finance deficit in 2003/2006 (% of GDP, ESA 95)	public debt in 2003/2006 (% of GDP, ESA 95)	meeting the fiscal criteria
Czech Rep.	2009 - 2010	-6,3 % / -4 %	19,5 % / 36,7 %	2008
Hungary	2008	-4,9 % / -2,5 %	55% / 49 %	2006
Poland	2008 - 2009	-4,8 % / -3,3 %	44,3 % / 58,7 %	2007
Slovakia	2007 - 2008	-5,3 % / -3,3 %	33,2 % / 00 %	2006
Slovenia	2007	-1,27 % / -0,7 %	26% / 24 %	2004
Estonia	2007	-0,5 % / -1 %	5,5 % / 3,1 %	2004

Underestimation of the public finance reform may lead to a significant delay in adopting a common currency. It is important to start – as soon as possible – a reform on both the expenditure and the revenue side that will result in a long-term stability of public budgets and that will create sufficient margin of manoeuvre for a stabilizing fiscal policy. The measures taken as part of this reform should not jeopardize the process of real convergence[12]. In the following paragraphs we will look at the roots of the Czech Republic's budgetary problems and evaluate sufficiency of the proposed measures from the perspective of future improvements in the flexibility of budgeting in the Czech Republic.

Reforms: the revenue side and the expenditure side

The main reason for the growing deficit is growth in public expenditure in relation to GDP (see Chart 1) while the revenues-to-GDP ratio is stagnating. A more detailed analysis reveals the following:

1) Deficits grow especially due to the worsening state budget balance

This fact is well-evidenced by the data presented in the following table:

Table 3: Public budgets (balance according to GFS MMF methodology, in CZK billions). Source: Czech National Bank

	1999	2000	2001	2002
state budget	-29,6	-46,1	-67,7	-45,7
local budget	18,5	-2,5	-11,2	-4,3
public financial assets	-5,2	-5,7	.	.
state funds	-0,6	2,6	11,2	12,3
the Land Fund	-0,3	-0,5	-0,1	-0,5
the National Property Fund	2,9	-11,5	13,2	28,4
health insurance companies	2,5	2,1	1,4	-1,2
others	0,7	-0,4	0,9	-0,8

2) The deficit does not grow due to transformation costs

Table 4: Extra public budget revenues and expenditures. Source: Czech MF (public finance reform conception)

CZK billions	Privatisation	TI subsidies	Difference (privatis.-TI)
1993	26.3	0.0	26.3
1994	31.7	0.0	31.7
1995	27.1	3.4	23.7
1996	25.7	11.1	14.6
1997	13.8	11.6	2.2
1998	15.5	18.4	-2.9
1999	26.0	7.6	18.4
2000	20.5	20.1	0.4
2001	59.9	51.1	8.8
2002	126.6	64.0	62.6
TOTAL	**373.1**	**187.3**	**185.8**

What we can consider as transformation costs are extra costs in the form of subsidies provided to "transformational institutions"[13] minus extra revenues from privatisation. Public budget deficits do not grow due to transformation costs, as revenues from privatisation have always (with the exception of 1998) exceeded the subsidies provided to transformational institutions. The fact that public budget deficits rise due to other factors is illustrated in Chart 1, in which the deficit is cleared of extra revenues and costs.

On the other hand, these figures cannot be presented as very optimistic. Through the transformational institutions a lot of non-standard operations were done by which the government realized its fiscal policy so that it is not reflected in the current public budget balance. This resulted in an accumulation of hidden debt in these institutions, which sooner or later will get reflected in the balance of the public budget. Besides the hidden debt of the transformational institutions, significant risks are posed also by the high amount of provided governmental guarantees (Czech Railways, IPB). The overall volume of non-budgetary obligations and guarantees (in relation to GDP) compared to the actual ratio[14] of gross public debt to GDP is well illustrated in the following table.

Table 5: The state's non-budgetary obligations and guarantees. Source: OECD

	1994	1995	1996	1997	1998	1999	2000	2001
non-budgetary obligations and guarantees (% of GDP)	9,7	7,9	8,3	11,4	11,9	14	14,2	18,9
gross public debt (% of GDP)	17,6	15,3	13,2	12,9	13,0	14,5	16,7	18,7

In order to cover the hidden liabilities, other one-off revenues from privatisation will have to be used in the future. This, unfortunately, limits the possibility to use the privatisation revenues for system changes (such as a thorough reform of the pension system).

What can be seen as positive in this regard are the measures proposed within the public finance reform conception, namely: the government's pledge not to transfer new bad assets to the Czech Consolidation Agency[15], to accelerate closedown of the transformational institutions, and to create reserves (according to the degree of risk) for both former and new guarantees.

3) The increase in expenditure is pushed especially by the growth in mandatory[16] and quasi-mandatory expenditures[17]

Mandatory expenditures are either given by law, or they result from other more or less fixed state obligations. The high amount of these expenditures to a great extent hinders the manoeuvrability of the public budget expenditure policy. At present mandatory expenditures represent 55% of the overall state budget expenditure; any further growth in this percentage will cause a (roughly) half-percent increase in the overall expenditure. Together with quasi-mandatory expenditures they represent no less than 81.4% of the total state budget expenditure. Table 2 shows the most significant mandatory expenditure components and how they have grown so far. It is evident that social transfers constitute the highest proportion. As the proportion of these transfers to the state budget is quite high, they greatly contribute to the growth in its expenditure.

Table 6: Mandatory expenditures. Source: OECD, calculations done by the author

Component	Proportion in the state budget (2003)	Growth (1997-2003)	Contribution to the overall increase in state budget expenditure (1997-2003)
Mandatory expenditures given by law; of which:	**50,40 %**	**55,50 %**	**26,27 %**
- social transfers[18]	40,40 %	54,00 %	20,71 %
- state contributions to the health insurance system	4,00 %	75,50 %	2,53 %
- debt service	2,90 %	33,00 %	1,06 %
- building savings contributions	1,60 %	236,80 %	1,64 %
- other mandatory expenditures given by law	1,50 %	20,40 %	0,36 %
Other mandatory expenditures (especially those associated with state guarantees and loans)	**2,03 %**	**158,70 %**	**1,82 %**
Quasi-mandatory expenditures; of which:	**25,23 %**	**70,80 %**	**15,28 %**
- the army	5,90 %	65,50 %	3,38 %
- public administration salaries	16,40 %	44,30 %	7,17 %
Other state budget expenditures	**22,34 %**	**9, 00 %**	**2,69 %**
Overall state budget expenditure	**100,00 %**	**46,01 %**	**46,01 %**

Between 1997-2003 the overall state budget expenditure increased by 46 percent. Mandatory expenditures contributed to this increase by roughly 28 percent. Social transfers alone made up about 21 percent of the overall increase in public expenditure[19].
There was an enormous growth in building savings contributions and expenditures associated with state guarantees and loans[20]. The state's contributions to the health insurance system have been growing considerably, too. Quasi-mandatory expenditures (the largest part of which is constituted by defence spending and public administration salaries) further contribute to the overall growth in expenditure by 15 percent[21].

Therefore, budgeting problems were primarily caused by growth in budget expenditure, which results from growth in mandatory and quasi-mandatory expenditures. Their increase limits the flexibility of budget management and, accordingly, lowers the capacity to act as a stabilizing factor when a common currency has been adopted. A seriously taken reform aimed at bringing long-term stabilization of public finance should therefore be oriented towards, above all, lowering the proportion of the budget's mandatory and quasi-mandatory expenditures. Areas greatly contributing to the growth in expenditure should be the main focus of attention; these include expenditures that represent a high proportion of the overall expenditure and that have increased in recent years, i.e. social transfers (the pension system, social security payments, sick benefits) and public administration salaries. Other significantly growing expenditures should be observed, too: building savings contributions, expenditures associated with state guarantees and loans, and the growing state contributions to the health insurance system.

The government's public finance reform also declares that measures regarding the expenditure side should prevail. The reform is divided into two stages. In the first stage (up to 2006) 60-75% of all expenditure-related measures will be adopted so that the overall public budget deficit[22] goes down below 4% of GDP[23]. The individual measures regarding the expenditure side and their impact on the state budget are summarized in the following table.

Table 7: Measures regarding the expenditure side. Source: Czech MF

active expenditure-related measures	**overall fiscal impact on the state budget (2003-2006), CZK billions**	**overall fiscal impact on the state budget (2004-2006), percent**
pensions – parametric changes	-0,2	-0,1 %
pensions – revaluation speed	8,6	4,5 %
sick benefits	**22,2**	**11,8 %**
social security payments	1,3	0,7 %
social benefits	1,7	0,9 %
building savings	1,2	0,6 %
Introduction of a 16-grade salary system and a drop in the number of employees in state organizational components (SOC) by 2% a year	**65,9**	**34,9 %**
salaries – moratorium on increasing the number of jobs in central SOC	2,4	1,3 %
salaries – freezing state officials' salaries at the 2003 level	0,3	0,2 %
salaries - education	4,5	2,4 %
drop in expenditure on debt service with a lower deficit	**13,6**	**7,2 %**
additional cuts (defence, research and development, subsidies provided to companies etc.)	**67,4**	**35,7 %**
active expenditure-related measures (sum total)	188,9	100 %

Of the proposed measures, the greatest effect is expected from the additional cuts, lowering the number of employees in centrally-governed public services (34.9% of the overall effect), and changes concerning sick benefit payments (11.8% of the overall effect). As other measures (lowering the debt service expenditure excluded[24]) will in three years' time bring less than 17% of the overall effect, we can consider the above-mentioned measures as the key expenditure-related measures in the first stage of the public finance reform. What can be seen as positive are the efforts to lower the number of employees in centrally-governed public services by means of personnel and organizational audits. Salaries in the public administration sphere constitute a considerable proportion of the quasi-mandatory expenditures (see Table 4). Lowering the amount of these salaries – through rationalization and improvements in the efficiency of public authorities – is a change that could bring long-term savings. On the other hand, changes in the system of sick benefit payments (which will bring the second most significant effect) are of parametric nature[25], and it does not seem that they could considerably and in the long term contribute to the lowering of mandatory expenditures. The additional cuts, by which the government achieved 35.7% of all savings, came "in the last moment" and are not coupled with more significant system changes.

The measures to be taken in the first stage of the reform lack more radical system changes. The government's document itself mentions them but only in the sense that they will take place in the future. These changes should include, above all, reforms in areas that increase the proportion of social transfers, namely: a radical reform of the pension system (to be prepared by the Ministry of Labour and Social Affairs, see Box 2), a thorough reform of the health insurance system[26], and changes in the social security system[27].

Public budgets struggle with a long-term problem of the ageing population, which causes growth in pension system expenditure[28]

The structure of social transfers and its development is illustrated in Chart 2, which shows the absolute growth (in CZK billions) broken into the individual components. Within the social transfers, pension payments constitute the highest proportion (70% in 2003); they also greatly contribute to the state budget expenditure (28% in 2003)[29]. If the current pension system is maintained, its deficit will burden the state budget more and more. The development of the pension system revenue and expenditure[30] is shown in Table 8. Unless the system parameters are modified the debt may become difficult to control.

Chart 2: Social transfers. Source: OECD

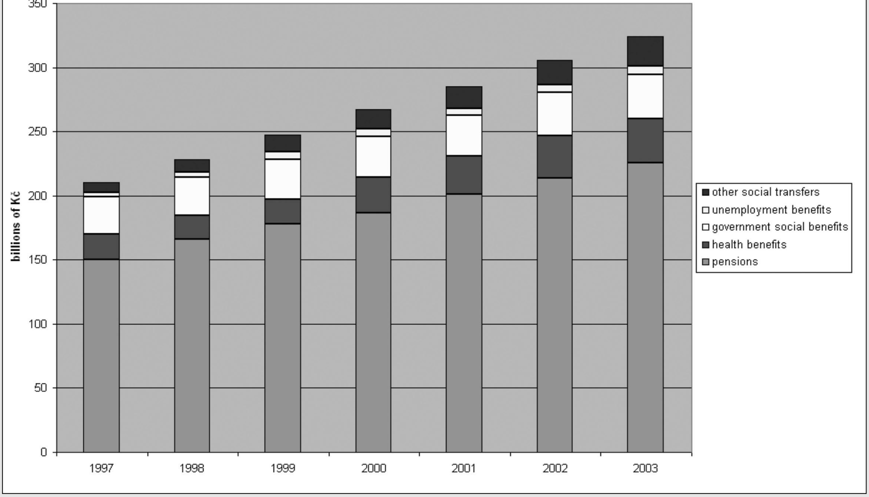

Table 8: Pension system revenue and expenditure. Source: Bezděk 2000, Czech Ministry of Labour and Social Affairs

year	revenue	expenditure	balance
1996	133,9	129,5	4,4
1997	146,3	152,8	-6,5
1998	156,3	168,8	-12,5
1999	161,8	181,3	-19,5
2000	170,0	186,8	-16,4
2001	186,0	201,0	-15,0
2002	192,3	209,9	-17,6

Modification of the system parameters provides certain chances; this modification includes: increasing the retirement age, changes in the indexation of payments, and changes in the contribution rate. However, in the long-term perspective the combination of parametric measures appears to be difficult to put through and (taking into account other objectives of the economic policy) unrealistic. A considerable increase in the retirement age, a significant drop in pensions in proportion to wages and salaries, or an increase in the already quite high pension contribution can, on the one hand, ensure long-term stabilization of the pension system from the macroeconomic point of view. On the other hand it is evident that with the current demographic trend, such parametric changes could have a negative impact on the inhabitants' financial situation: they would pay even more in their productive years and receive even less when retired[31]. Therefore it will be necessary, sooner or later, to reform the existing system more thoroughly (to base it upon more pillars). According to international experience, turning the existing system into a system partly based on pension funds[32] is very costly and is, therefore, associated with temporary excess deficits of the state budget. Postponing these fundamental reforms until considerably later could jeopardize the fulfilment of the Maastricht criteria and/or result in breaking the current rules of the Stability and Growth Pact[33] and subsequent sanctions[34].

4) There are not many opportunities to perform the public finance reform through the revenue side

There is not enough room for increasing the tax-to-GDP ratio. The proportion of taxes and social security contributions[35] to the public budget revenue is decisive, and thus a reform focused on increasing the ratio of state budget revenue to GDP is not really practicable. The overall tax-to-GDP ratio (including compulsory social and health insurance contributions) is relatively low when compared with more developed EU countries but too high in comparison with countries at the same level (see Table 9). The high taxation hinders the development of the private sector to a great extent. Further, countries at a lower level of economic development compete against each other for foreign investments, which support real convergence. High taxation puts foreign investors of[36].

Table 9: Tax-to-GDP ratio in 2000. Source: Czech MF and OECD

Denmark	56 %
Sweden	55.6 %
Austria	46.7 %
Czech Republic	39.40 %
Hungary	39.10 %
Greece	37.80 %
Slovakia	35.80 %
Switzerland	35.70 %
Spain	35.20 %
Portugal	34.50 %
Poland	34.10 %
Ireland	31.10 %
EU 15	41.60 %
OECD	37.40 %

For the reasons given above we believe that a reform that would lead to increasing the tax-to-GDP ratio could be dangerous and might jeopardize the process of real convergence in the future. Moreover, such a reform does not primarily address the source of the country's budgeting problems, which is on the expenditure side.

The revenue-related measures of the government's reform scenario are expected to improve the revenue side of the budget by about 63 billion CZK between 2004 and 2006. The main factor contributing to this increase is the harmonization with the EC legislation in the field of excise taxes[37] and VAT[38]. Measures concerning the VAT will bring the most significant effect. According to EU standards, certain goods and services that used to be taxed at a reduced rate have to be taxed at the standard rate now. However, as the difference between the standard and the reduced rate of VAT is bigger compared with any country in the EU, the standard rate will have to go down gradually. The government has so far lowered the standard rate to 19% for the time being; however, there is a possibility to lower the rate even further[39]. Therefore, effects on the public budgets balance resulting from changes in the VAT should be taken as temporary and not regarded as a systematic solution of the problem.

Even when seen from other perspectives, there is more room for lowering than for increasing on the revenue side. Taking into account the high tax competition as regards the corporate income tax, we believe that the tax rate should be lowered[40]. It is often possible to achieve greater revenue by lower taxation (Luxembourg, Ireland) than the other way round. There are opinions that tax competition will contribute to a gradual elimination of this tax. In the context of the EU, the Czech Republic unfortunately occupies the first place in the proportion of social and health insurance (44%) to the overall revenue from taxation and insurance payments. Here, too, the burden should be lowered rather than increased.

Due to the reasons given above we believe that measures regarding the revenue side are – along with the necessary synchronization with EU legislation – motivated especially by efforts to temporarily fill the gaps in the budget. Significant changes on the expenditure side should take place from the very beginning of the reform, so that the overall tax-to-GDP ratio can be lowered in the long run.

Reforms in the preparation, implementation and assessment of the state budget

A long-term balanced budget management needs a transparent framework for budget preparation, implementation and assessment. Above all, the system should include longer-term aspects of budgeting and natural limits to annual growth in expenditure, which could experience one-off political pressure. Without sufficient limits, short-sighted political behaviour could jeopardize completion of long-term economic policy objectives. This includes the fulfilment of the fiscal criteria, and the overall ability of the fiscal policy to act as a stabilizing factor when a common currency has been adopted.

During most of the 1990s the governments prepared budgets without a conception, from year to year, without any long-term outlook. The considerable lack of transparency in budget management (given especially by a large number of extra-budgetary funds and by the existence of the transformational institutions) has logically pushed the growth in the overall expenditure, and has made the expenditure less effective. If the Czech Republic wants to joint the Eurozone, the fiscal policy framework will have to be made more transparent and controlled by better-defined rules. It is necessary to stop preparing the budget without a conception, in a haphazard fashion. Rather, annual budgets should automatically result from an approved medium-term strategy of the governmental fiscal policy.

The government's public finance reform tries to introduce the principle of fiscal targeting into the budgeting process. This principle should make the current as well as the future government think about its revenue and expenditure from a medium-term perspective. Thus, parliamentary discussions should change focus from one-year planning to conception-based multi-year budget preparation. The government will, first, determine a target public budget deficit[41] as a percentage proportion to Gross Domestic Product, for the following three years' period. Then it will prepare an autonomous fiscal outlook scenario[42], based on a conservative macroeconomic forecast. In reaction to this scenario, the Finance Minister may propose various measures regarding the revenue or the expenditure side. Having considered these measures, the government will determine an obligatory medium-term expenditure framework (MTEF) based on a projection of budget revenues and on the given target deficit. This framework will provide an obligatory limit to government spending for each year of the respective three-year period. It is the central government's MTEF that will be subject to legislative approval together with the state budget, not the proportion of the public finance deficit to GDP. Annual budgets will be derived from the MTEF. In connection with the fulfilment of the Maastricht fiscal criteria and future adherence to the Stability and Growth Pact rules, fiscal targeting can turn out to be a relatively powerful weapon: it will force governments to prepare their budget strategies well in advance so as to avoid excess deficits.

On the other hand, the proposed solution bears certain risks. These include, above all, the quality of the macroeconomic forecast. If the real growth is lower than expected, the overall budget revenue is lower while the amount of the government's aggregate expenditure is given by the plan. Therefore the absolute deficit is higher. And as GDP is lower than expected, the deficit-to-GDP ratio significantly rises. While the government does not commit itself to targeting the deficit-to-GDP ratio[43] and targets the obligatory MTEF instead, there exists a risk that future growth will be overestimated. Although the government manages to stay within the expenditure limit, the planned deficit-to-GDP ratio will be greatly exceeded. Therefore, taking into account the key role of the macroeconomic forecast, the question remains whether the economy's future growth should be analysed by an independent institution, in order to prevent pressures towards overestimation of the growth[44].

We endorse the efforts to lay stress on performance-oriented budgeting (dividing the MTEF into individual chapters), i.e. efforts to make particular officials and chapter administrators more interested in achieving particular outputs in an efficient and economical way. This principle (where on the one hand the officials need to get more freedom to make decisions regarding the means and particular inputs, on the other hand accurate measuring systems for assessing their outputs have to be introduced) is mentioned in the OECD best practices, for example. The fundamental problem of this approach is how to choose suitable measuring systems[45]. It is also necessary to give chapter administrators enough freedom so that they are able to achieve the given outputs. At the same time, it is necessary to ensure that they are really motivated to seek savings while performing expenditure audits[46]. According to the draft of the reform, the Parliament should not influence the division of the MTEF into chapters. This is important: the Parliament is expected to review the medium-term aggregate expenditure framework only; the division into chapters will be eventually determined by the government. This, on the one hand, gives lobby groups few opportunities to further increase budget expenditure through the Parliament. On the other hand it makes the government more responsible for means allotment based on an audit of the individual program activities and for the assessment of performance based on the given measuring systems.

The new regulation of the state budget's institutional framework should definitely support conception-based budgeting in the Czech Republic. Whether it will eventually result in further savings in government spending and in the fulfilment of the fiscal criteria will depend especially on the government's ability to perform radical reforms within a fiscal targeting framework, to make accurate macroeconomic forecasts, and to remain within the given expenditure limits. At any rate, an indisputable advantage of the new system is that it will transparently show the existing problems.

Conclusions

- Public finance in the Czech Republic is characterized by growing public budget deficits and a relatively low (but rapidly increasing) public debt. As this development poses a number of general risks, the government will have to begin the public finance reform at all events. The reasons for a quick consolidation of public finance include the Czech Republic's accession to the European Union and the strategy for joining the Eurozone. It is necessary to not only meet the Maastricht Fiscal Criteria but also to reform public finance thoroughly enough so that the fiscal policy performs a stabilizing function during the participation in ERM 2 and after adopting the euro. Unless sufficient fiscal consolidation takes place there is a risk that the adoption of a common currency will be postponed further into the future. We believe that a euro adoption that would take place much later than in the other transitional economies could be dangerous for the Czech Republic.

- The unfortunate state of public finance does not result from transformation costs (subsidies provided to transformational institutions minus revenues from privatisation). On the other hand, the state's non-budgetary obligations in the Consolidation Agency should not be underestimated. A large proportion of these obligations will have to be paid off using the remaining privatisation revenues; therefore, it will not be possible to use all of these revenues for system reforms.

- The budgeting problems exist largely due to the growth in the proportion of state budget expenditure to GDP. This growth is pushed by the increase in mandatory and quasi-mandatory expenditures. Their increase limits the flexibility of budget management and, to a considerable extent, lowers the fiscal policy's capacity to act as a stabilizing factor after joining the EMU. Social transfers (the pension system, social security payments, sick benefits) made the greatest contribution to the overall growth in expenditure, especially between 1997-2003. The reform efforts should focus, in particular, on these transfers. Unfortunately, the draft of the first stage of the public finance reform lacks more radical reforms of the pension system and of the social security payments. Such radical changes are expected to take place in the second stage of the reform.

- There are not many opportunities to perform the public finance reform through the revenue side The Czech Republic has the highest tax-to-GDP ratio of the newly accessing countries. Further rise in this ratio could jeopardize the process of real convergence. The main reform measures regarding the revenue side of the budget are connected with the synchronization of legislation in the area of VAT and excise taxes. A slight decrease in the corporate income tax rate is expected to result in a decline in revenue. Taking into account the fact that company taxation in the EU faces considerable tax competition, there is room for further decline in the corporate income tax rate. Lowering the proportion of social and health insurance to the overall amount of tax and insurance payments would also be desirable, as this proportion is higher than in any country of the EU. This would, however, require the above-mentioned system changes on the expenditure side to take place as well. In the long term, the consolidated tax-to-GDP ratio should decrease to a certain extent rather than grow. A reform focusing on the revenue side only would, moreover, disregard the real source of the current budgeting problems.

- Until today the budgeting process in the Czech Republic has lacked long-term aspects and fixed limits for the public budget. The lack of limits could result in politicised decisions to increase expenditure unnecessarily. This also poses the risk that in the medium term the government will not be able to implement its economic policy priorities. One of these priorities is the Eurozone accession, connected with fulfilment of the fiscal criteria. The principle of fiscal targeting will introduce an obligatory medium-term limit into the budgeting process; this will probably support a more conception-based approach to budgeting. However, the particular successes as regards long-term savings and lowering deficits will greatly depend on how radical the government's reforms will be.

Notes

[1] The fiscal projection works with estimations of deficits measured using the ESA 95 methodology, which is close to the current budget concept. As the Czech Statistical Office publishes the deficits according to the ESA 95 with a considerable delay, the Ministry of Finance uses estimations. It is the methodology used for assessing the fulfilment of the fiscal criteria.

[2] We consider only a partial effect of Ricardian equivalence in transitional economies, i.e. the decline in governmental savings is only partly compensated by an equivalent growth in private savings.

[3] Further, a greater outflow of revenues can be expected.

[4] It can hardly be assumed that with a decline in economy, increase in the already quite high deficit will have a stabilizing effect on the output. Lower confidence and higher interest rates will exceed impacts of the expenditure multiplier.

[5] Although the Commission cannot impose sanctions on the Member States that have not adopted a common currency yet, negative assessment could influence the Czech Republic's future position in negotiations regarding the adoption of a common currency. On the other hand, the question is to what extent the current rules of the Pact will remain valid in the future.

[6] Central parity is not necessarily unchangeable, and ECOFIN can modify it following the Commission's proposal. Also, going beyond the fluctuation band does not necessarily mean breach of the exchange rate criterion. The final judgement will be given by the ECOFIN, which will probably decide after considering the extent and length of the deviation.

[7] However, at that time it was not completely clear how radical a reform we can expect.

[8] With a significant share of trade with the other Members.

[9] See for example Mandel, Tom_ík (2003), D_dek (2003), or The Czech Republic's Strategy for Eurozone Accession (2003). Most authors agree that the fiscal policy will be of key

importance especially during the ERM 2 participation and in the first years after adopting the euro. With growing harmonization of economic development the risk of asymmetrical shocks should decline.

10 See Chart 1 and Table 1.

11 In its strategy the Ministry of Finance provides estimation up to 2006 only. A longer-term forecast was prepared for example by Patria Finance; available on: http://www.patria.cz/generated/ek_analyza/Budoucnost_verejneho_dluhu.pdf

12 Here we refer to, in particular, measures regarding the revenue side.

13 The Czech Consolidation Agency financial group and _eská inkasní.

14 At present the public debt is shown including CCA obligations.

15 Starting already from 2004.

16 Mandatory expenditures are expenditures that result from laws, other legal regulations and the state's contractual obligations. For instance: social transfers, pension scheme payments, building savings, health insurance contributions, debt service and guarantees.

17 Above all, defence spending and salaries for public administration employees.

18 The concept of social transfers is different than according to the ESA 95 methodology. Here they are given without education spending and the overall health service expenditure; besides, the figures include contributions to the building savings system.

19 See Box 2 for details concerning the growth in social transfers.

20 Nevertheless, due to its small share in the overall budget expenditure, the enormous growth in building savings contributions does not have too serious an impact on the overall budget management.

21 The excess amount of quasi-mandatory expenditures could result from inefficient and uneconomical performance of the public administration sphere (non-transparent public procurement practices, over-employment).

22 State budget + state funds + health insurance companies' budgets + municipal and regional budgets – revenues from privatisation and transformational institutions' expenses.

23 From this figure all respective expenditure limits for the central government's budget and the state budget are derived.

24 We believe that this cannot be considered as an active expenditure-related measure in the proper sense of the word, as it automatically ensues from the adopted measures, both expenditure- and revenue-related. By saying this we do not want to downgrade the importance of this factor. We merely want to note that it is a positive result of a reform rather than the reform itself.

25 A moratorium on increase in reduction limits, prolongation of the period in which the assessment basis is determined, reduction of the assessment basis during the first 14 days of the sick leave, and reduction of the daily allowance for the first three days of the sick leave.

26 The reform scenario plans to start a more radical reform in 2005.

27 A more radical reform to be started in 2006.

28 Not only the pension system expenditure but also the state contributions to the health insurance system.

29 Due to the great proportion of pension payments (28% of the overall state budget expenditure, 70% of all social transfers), their increase has contributed to the growth in social transfers to the greatest extent.

[30] Due to the great proportion of pension payments (28% of the overall state budget expenditure, 70% of all social transfers), their increase has contributed to the growth in social transfers to the greatest extent.

[31] The actual calculations see for example Bezd_k (2000).

[32] The aim of this text is not to analyse the options of a pension system selection. The important thing is that the transition to a system in which people partly save (either on an obligatory or a voluntary basis) for their retirement is associated with short-term higher costs and long-term savings.

[33] It is known that the current rules of the Pact do not provide the Member States with opportunities for more radical budget reforms (a reform of the pension system) connected with temporarily higher deficits.

[34] The current government has plans for the pension system reform. Although exact details have not been specified, the new system will probably be based on the Swedish model. The Ministry of Labour and Social Affairs will prepare a draft, which is expected to be submitted for approval in 2005; changes should take place after 2010. (Details: Kopeck_, Josef. "Vláda: Nové penze _ekají _ty_icátníky. (The Government: New pensions for today's 40-year-olds)". Hospodá_ské noviny. 19 November 2003).

[35] In the Czech Republic the share of social security contributions in GDP is exceptionally high.

[36] Foreign investors are discouraged by, in particular, the high taxation of corporate income (lowers after-tax profit) and the high taxation of labour (increases labour costs). A current example is the decision of the car manufacturer Hyundai Motor. For its investment of 1.5 billion dollars, the company gave preference to Poland and Slovakia. One of the main reasons was the higher tax burden in the Czech Republic.

[37] Excise tax-related measures are relatively well-defined by European requirements, so the margin of manoeuvre is quite narrow in this respect.

[38] Transfer of certain goods and services from the reduced rate to the standard rate range; lowering of the minimum turnover limit needed for VAT registration.

[39] It is theoretically possible to lower the rate of VAT from the current 22% to 15%. According to many experts, high VAT rates result in greater tax evasion.

[40] There are plans to gradually lower the corporate income tax from the current 31% to 24% before 1 January 2006.

[41] According to the draft of the reform, the target should be determined for the deficit in a broader sense (however, this target would be less obligatory) as well as for the deficit in a narrower sense (state budget and state funds), which would be obligatory to a greater extent.

[42] The autonomous fiscal scenario should be based on the existing legal and institutional environment.

[43] The government actually cannot do this because in many cases the fiscal policy could have a significant procyclical effect.

[44] In the Netherlands, the amount of aggregate expenditure is targeted in the medium term, too. The analysis of the future economic development is done by the independent CPB (Central Planning Bureau), which presents the government with two scenarios of the future economic development. One of them tries to provide the best estimate of the real economic development, the other scenario takes into account possible risks of growth overestimation (therefore, its predictions are generally closer to reality).

[45] The good old management rule "what you measure, you manage" applies here. The draft of the reform plans to trace either outputs (processed applications, closed legal cases, frequency of inspections) or effects (lower road accident frequency, decrease in criminal behaviour, etc.).

[46] The government's public budget reform conception plans to establish a system in which administrators who find savings do not receive reduced financial means from the budget. The system will also allow transferring means to other effective programmes. On the other hand, administrators who show uneconomical behaviour will obtain less money. The question remains, to what extent will this approach be applied in practice? The questionnaire-based "expenditure audits" that took place in the first half of 2003 showed that the officials tend to ask for more financial means and disregard the requirements of economy and efficiency by adopting formal measures. It was also shown that they are unable to set priorities as regards performance-oriented budgeting. Therefore, a change from institutional financing to performance-oriented financing seems to be a long-term issue.